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United States Department of Agriculture
Farm Credit Administration
Washington, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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U. S. DEPARTMENT OF AGRICULTURE

For the

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Summary No. 23 September 1944

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San Joaquin Case Followed

The Tax Court of the United States in the case of Milk Producers Association of Central California v. Commissioner of Internal Revenue, Docket No. 575, decided on July 14, 1944, followed the ruling of the Circuit Court of Appeals in San Joaquin Valley Poultry Producers Association v. Commissioner, 136 F. 2d 382, and held that the money on which the Bureau of Internal Revenue sought to require the Association to pay taxes was not income of the Association but the property of its members, and hence that the Association was not taxable thereon.

As in the San Joaquin case, the Association was incorporated under the statute of California providing for the formation of nonprofit cooperative corporations. Its organization papers provided that it was organized to operate at cost. Unlike the San Joaquin case, the organization papers of the Association did not specifically stipulate that amounts which might be retained or deducted over and above operating costs and expenses were the property of the members. In the San Joaquin case the organization papers provided that "The 'net proceeds' resulting from the operation of the business, if any, shall belong to the members," while in the instant case there did not appear to be a provision specifically covering this matter.

In the case under discussion the Association was engaged in the marketing of milk and other dairy products, and it functioned strictly on an agency basis and therefore did not purchase from its members any of the commodities it was engaged in marketing. In this connection the tax court said:

> "It does not buy the milk or cream from the producers at any stated price, but collects, manufactures, and sells their dairy products to the best advantage possible, accounting to them for the proceeds.
>
> "The sales proceeds are handled by the petitioner in the following manner: After the end of each month the expenses of the preceding month are estimated and deducted from the gross proceeds of sales made that month; there is also deducted an amount, usually $2,000 or $3,000, which is used for working capital. Special amounts have also been withheld. On one occasion 1 cent per pound of butterfat was withheld to provide funds to build a condensary; and on another occasion 3/8th cent per pound of butterfat was withheld to repay a mortgage. The remainder of the estimated gross proceeds is turned over as an advance to the producers on the basis of the butterfat content of the milk and cream delivered by them. The amounts retained by the petitioner vary from month to month by reason of market conditions, the Association's need for money, and competitive conditions. The petitioner operates in a highly competitive field and the advances made are gauged by the market price set by this competition. As an aid against the competition, the petitioner aimed to give its members better service, and to create a higher market price by reason of being in business for its members."

The court, after quoting from the opinion in the San Joaquin case, said:

> "Similarly, in the instant case, the petitioner's articles of incorporation and its by-laws provide that 'this Association is organized for purposes of mutual help, without capital stock, to serve its members only and provide all of its facilities to them at cost, pro rated according to volume and value of business done, upon uniform rules and regulations to be prescribed by the directors of the Association.' The preamble to the petitioner's by-laws likewise provides that it is a cooperative nonprofit corporation, without capital stock and not conducted for profit.
>
> "There is no provision in either its articles of incorporation or its by-laws under which the petitioner could accumulate earnings. Its purpose is nonprofit, to provide its facilities to its members at cost. Therefore, all of the income, with the exception of that needed to defray current expenses, is the property of its members, and it is under a direct liability to refund those sums to them."

Although the court states that the Association was "under a direct liability to refund those sums to them," it is not believed that it was intended to convey the idea that a member of the Association could maintain a suit against the Association for the purpose of recovering any of the deductions which the Association had made from the proceeds arising from the sale of his commodities, and apparently the Association had complete jurisdiction over the funds in question, which were subject to be revolved as determined by the board of directors. In this connection the following quotations are applicable:

> "The amounts withheld from gross sales by petitioner, known as 'members' retains' or 'members' equities,' were reflected in an account called Members' Retains Account or Members' Equity Account. At the end of each year when the books are closed, entries are made reflecting the sums withheld from all members and also any overdistribution to members. This information is entered by years from the beginning of the association.
>
> "No liability accounts were set up showing in dollars and cents the credit to each individual member. However, a card record account was kept for each member, known as his capital account. On these cards was entered month by month the amount of butterfat shipped by a member, and from them each individual's interest in the Retains Account was readily computable at any time.
>
> "The petitioner operates on the revolving fund system, which it adopted in 1924. Under this system, the amounts withheld from the members are retained by the petitioner for a number of years, for use as working capital and for the special purposes above mentioned. In a later year, the amounts so withheld are to be returned to the

members on a patronage basis, out of earnings of the current year. It was hoped that these distributions could be begun in 1929, but because of economic conditions, the petitioner was financially unable to do so.

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"In 1936 a resolution was passed authorizing a distribution of retains for the years 1927 and 1928. These years were joined because the year 1927 showed a deficit, that is, there had been an overdistribution to members during that year. In such circumstances, it is the petitioner's practice to make a two-year distribution period, charging against the member the amount that he was overpaid in the overdistribution year, and taking it out of the retains due him for the following year. This is the usual procedure among cooperatives operating on a revolving fund system, and it is the only feasible way of collecting back the overdistribution."

It is believed that the money retained by the Association and on which the Commissioner sought to require it to pay taxes could have been regarded as money that was capital at the instant of receipt. Indeed the tax court, after referring to the small membership fees which members were required to pay, said: "These fees have been entirely inadequate to finance the petitioner's needs and have barely covered the cost of soliciting members."

Again the court, referring to the deductions in question, said that amounts "usually $2,000 or $3,000, which is used for working capital," were deducted each month. The court also said: ". . . a card record account was kept for each member, known as his capital account."

Obviously, if the court had found that the amounts in question were capital at the moment of receipt, the amounts in question would not have been taxable because it is clearly established that capital is not income and hence no income taxes could be required to be paid thereon.

The tax court laid considerable stress upon the fact that the Association was organized under a statute providing for the formation of nonprofit associations and that its organization papers contemplated that it would operate on such a basis. It should be emphasized that income and profits are not synonymous. Income taxes are required to be paid on income, and income may or may not consist of profits.

In the case of Baboquivari Cattle Co. v. Commissioner of Internal Revenue, 135 F. 2d 114, the court held that one receiving a payment under the Soil Conservation and Domestic Allotment Act in pursuance of a contract which required him to comply with certain conditions relative to the use of his land had received income which was taxable, but such payments were not profits.

One working for a salary or wages has taxable income, but clearly the salary or wages do not constitute profits. Even though it is established that a corporation, cooperative or otherwise, is functioning on a nonprofit basis, this in and of itself does not establish that it has no taxable income.

In brief, a nonprofit organization may receive taxable income, and if it is not exempt from the payment of income taxes it may be required to pay income taxes on such income. This is precisely what was done in a case involving a nonprofit organization, namely, that of Underwriters' Laboratories v. Commissioner of Internal Revenue, 135 F. 2d 371, a case in which the taxpayer was not engaged in selling anything; but the corporation was required to pay income taxes on its net income although it was admitted that the taxpayer was a nonprofit corporation. To show that a nonprofit nonexempt organization is free from liability for income taxes, it should be established either that it has no income or that it has no net taxable income after making allowable deductions.

There is a wide and complete difference, however, between the receipt of income and the receipt of capital. No liability for income taxes arises from the receipt of capital. Obviously a nonprofit organization may have as great need for capital as a comparable organization formed and operated for the making of profits. More capital might be required to operate a business which is to function on a nonprofit basis than to operate a similar business which functioned on a profit basis. There is no inconsistency between an association operating on a nonprofit basis and receiving capital.

In the instant case it is submitted that the amounts of money which were retained by the Association over and above operating costs and expenses were deducted for capital purposes, and if the organization papers had specifically stated that these deductions were to be made for capital purposes it is not believed there would have been any basis on which it could have been claimed that income taxes should be paid thereon. It appears that the only factor absent was the identification in words that the money in question was authorized to be deducted for capital purposes. But the facts should speak for themselves, and the absence of the appellation of capital in the authorization for the deductions should not operate to alter their status.

The revolving fund plan of financing is, of course, entirely applicable to an association engaged in the revolving of capital. An anomalous situation is presented, however, where an association is said to be operating with money belonging to its members. If the money is actually the property of the members, then those interested in dealing with the association should carefully ascertain if the association is entitled to use the money belonging to the members of the association for the purposes involved.

In the case of the ordinary commercial corporation the assets of the corporation belong to the corporation and it has full and complete title thereto. But the stockholders of the corporation own the corporation and in dissolution, after the payment of its debts, the assets of the corporation are distributable among its stockholders. It is believed in the case of cooperative associations that they are on a sounder and more conventional basis if it may correctly be said that they own "their assets" and have full and complete title thereto, although the assets may be in whole or in part on a revolving fund basis and be ultimately distributable on the basis of patronage.

There is no reason why a cooperative association should not be permitted to accumulate capital through deductions from sale proceeds and have this capital free from liability for income taxes in the hands of the cooperative, just as money furnished to commercial corporations for capital purposes is free from liability for income taxes in the hands of the corporation.

Money - Income Year of Receipt

The headnote to the case of South Tacoma Motor Company, A Corporation, Petitioner, v. Commissioner of Internal Revenue, Respondent, 3 T.C. 411, reads as follows:

> "Petitioner sold, for cash, coupon books entitling the purchaser to certain services, which might be called for and performed after the year of sale. The purchaser had the right to rescind and receive a refund. The petitioner set up the amount received as a liability, and, when a coupon was later presented and service rendered, charged itself with an aliquot part of the original sale price as income, and entered as expense the cost of the service. Held, the entire amount received for the coupon books was income in the year when received upon sale. Brown v. Helvering, 291 U.S. 193; South Dade Farms, Inc. v. Commissioner, 138 Fed. (2d) 818."

Allowable Deductions

In the case of Greene County Farmers Sales Association v. United States, 55 F. Supp. 123, the Association, a nonexempt organization, filed suit for the recovery of certain taxes which it had paid "as a result of the disallowance of deductions of sums distributed to members of an association who made purchases from plaintiff, and as a result of disallowance of a deduction of a bad debt."

The Association was organized on a capital stock basis and all of its issued capital stock was held by 235 of the members of the Missouri Farmers Association. The court found that -

> "Plaintiff's by-laws from 1919 through the taxable years here involved provided that plaintiff's annual net income was to be disposed of as follows: (a) Ten percent to a reserve fund until the fund equaled 50 percent of the outstanding capital stock (the reserve fund reached this amount long before the taxable years in question); (b) a dividend of not to exceed 8 percent to stockholders; (c) the balance of the net income to be distributed to all persons who transacted business with plaintiff who were members in good standing of the Missouri Farmers Association in proportion to the amount of business which each such member had with plaintiff.
>
> *********
>
> "During the taxable years involved in this action plaintiff's stockholders received an annual dividend from it of 8 percent of the par value of the outstanding stock. This was the maximum dividend to which they were entitled. The balance of plaintiff's net profit was distributed to members of the Missouri Farmers Association in proportion to the total amount of business done with each member. Although plaintiff transacted business with the general public, only those of its patrons who were members of the Missouri Farmers Association shared in the distribution of its surplus profits. Profits which plaintiff realized from business with patrons who were not members were included in the total net profit distributed to members of the Missouri Farmers Association. These distributions were made pursuant to promises made by plaintiff to farmers who did business with it as an inducement to them to join the Missouri Farmers Association and as an inducement to deal with and through the plaintiff."

The Commissioner of Internal Revenue disallowed the amount distributed to the members of Missouri Farmers Association who were stockholders and patrons of plaintiff to the extent that he found that the sums in question were derived from business done by plaintiff with persons who were not stockholders of plaintiff and members of the Missouri Farmers Association. The court held that the Commissioner was wrong and that all the amounts distributed to stockholders and patrons of plaintiff who were members of

the Missouri Farmers Association were deductible in computing the amount on which plaintiff was required to pay income taxes. In this connection the court said:

> "Plaintiff's by-laws promised such rebates to members of the Missouri Farmers Association and these people bought on the faith of this promise and, so, could have enforced the payment of the rebate in a court of law. The obligation to pay it was an enforceable legal liability. As such plaintiff was entitled to deduct it, as a reduction of the amount which it in fact received for its goods sold. Uniform Printing & Supply Co. v. Commissioner, 7 Cir., 88 F.2d 75, 109 A.L.R. 966; Plymouth Brewing & Malting Co. v. Commissioner, 16 B.T.A. 123; Mertens Law of Federal Income Taxation, Vol. 4, par. 25.111."

Justice Littleton of the Court of Claims dissented, and expressed the view that the profits made by plaintiff on transactions with third persons and which were distributed to the stockholders of plaintiff on a patronage basis in addition to the refunds made by plaintiff on account of business done by them with plaintiff were not deductible. It is submitted that the views of the dissenting Justice appear to be correct.

It is, of course, quite obvious that where an association has agreed to return to a member the amount of any excess payments which he has made to the association over and above his share of the operating costs and expenses, that such amounts are allowable deductions. Under these conditions such excess payments could not be said to be profits, because the association is under obligation to return the amount involved to the person from whom it was received.

If, for instance, an association engaged in the handling of fertilizer received $5.00 per ton in excess of the actual cost of furnishing the fertilizer and was obligated to return the $5.00 per ton to the person from whom it was received, there is no possible basis for the view that the $5.00 per ton represents a profit to the association. On the other hand, in a situation in which a person has purchased fertilizer and the association is entitled to retain the $5.00 per ton with no obligation to return it to the nonmember from whom it was received, the fact that the association is under obligation to pay the $5.00 per ton made on the business of the nonmember to patron stockholders of the association on the basis of their patronage does not operate to cause the $5.00 per ton to cease to be a profit to the association. This is simply a way by which the profits made on nonmember business are to be distributed among patron stockholders.

It is not believed that there is any method by which profits made on the business of third persons can be distributed among the stockholder patrons of an association so as to relieve a nonexempt organization from liability for income taxes on such profits. The Bureau of Internal Revenue

has long held that such amounts are not deductible in computing the income taxes of a taxpayer (C.B. III-2, 238).

In regard to whether the Association was entitled to a bad debt deduction, all the Justices agreed that the Association was not entitled to deduct any portion of the so-called bad debt because the debt had not been ascertained to be worthless in the tax year in question. The court held that a bad debt could not be deducted by installments but that the debt, to the extent that it was regarded as worthless, must be ascertained as of the year the bad debt deduction was taken.

What Is A Mutual Insurance Company?

In the case of Mutual Fire Ins. Co. of Germantown v. United States, decided by the Circuit Court of Appeals for the Third Circuit, 142 F.2d 344, the company brought suit to recover an alleged overpayment of income taxes for the year 1938. Judgment was rendered in favor of the Government and company appealed.

> "The taxpayer claimed that it was a mutual fire insurance company which used or held its income for the payment of losses or expenses and consequently that it was entitled to be treated as a tax exempt corporation by virtue of Section 101(11) of the Revenue Act of 1938, 26 U.S.C.A. Int. Rev. Code § 101(11)."

This statutory provision reads as follows:

> "Sec. 101. Exemptions from tax on corporations. The following organizations shall be exempt from taxation under this title--
> * * * * * *
>
> "(11) Farmers' or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses."

The court then proceeded to discuss the characteristics that must be possessed by a mutual insurance company.

> "Neither the Revenue Act of 1938 nor the prior revenue laws define what is meant by a 'mutual' fire insurance company nor do they specify the tests to apply in determining whether a taxpayer is a mutual fire insurance company. The taxpayer urges that when the taxing act is silent the local law must determine and that by the law of Pennsylvania it is a mutual fire insurance company. When to apply the local law in construing federal taxing acts and when not to do so is a problem which continues to perplex the courts. It is settled that local laws are determinative if the taxing act so provides, either expressly or by inference. Subject to this exception the admonition in Burnet v. Harmel, 1932, 287 U.S. 103, 110, 53 S.Ct. 74, 77, 77 L.Ed. 199, that the taxing act 'is to be interpreted so as to give a uniform application to a nationwide scheme of taxation' still holds good. Acting upon this principle of uniformity in interpretation of the tax laws the Supreme Court has applied general rather than local law in determining whether a taxpayer was an insurance company. We think the District Court in the present case properly looked to the general law rather than the local law to determine whether the taxpayer was a mutual company within the meaning of the taxing act. Relying upon the general law the District Court held that one of the essential

characteristics of a mutual company is that it provide fire insurance protection to its policyholders substantially at cost. It found that the taxpayer lacked this characteristic.

"In no case, urges the taxpayer, has any court denied a mutual fire insurance company the status of a tax exempt corporation solely upon the ground that it did not provide insurance to its policyholders at cost. So far as our research discloses this is so. There are, however, several cases in this circuit in which it has been clearly indicated that this is one of the fundamental characteristics of a mutual company. The earliest of these cases, Mutual Benefit Life Ins. Co. v. Herold, D.C.N.J. 1912, 198 F. 199 involved a life insurance company. In that case the question before the court was whether the taxpayer, a mutual life insurance company, was subject to tax under the Corporation Excise Tax Act of 1909 upon so much of the premiums as it returned or credited to its policyholders. The court's ruling was that such amounts represented payments by the policyholders and not profits of the company. Judge Cross gave a lucid exposition of the manner in which level-premium mutual insurance companies operated and, referring to the portion of the premium paid in excess of the actual cost of insurance, said (page 205): 'This excess payment represents, not profits or receipts, but an overpayment--an overpayment because, being entitled to his insurance at cost and having paid more than it cost, he is equitably entitled to have such excess applied for his benefit.' This decision was affirmed by this court in a per curiam opinion, 201 F. 918, and certiorari was denied by the Supreme Court, 231 U.S. 755, 34 S. Ct. 323, 58 L. Ed. 468.

"That this was a correct description of the manner in which a mutual insurance company operates may be concluded from Justice Brandeis' statement in Penn Mutual Co. v. Lederer, 1920, 252 U.S. 523, in which he said at page 525, 40 S. Ct. 397, at page 398, 64 L. Ed. 698: 'In a mutual company, whatever the field of its operation, the premium exacted is necessarily greater than the expected cost of the insurance, as the redundancy in the premium furnishes the guaranty fund out of which extraordinary losses may be met, while in a stock company they may be met from the capital stock subscribed. It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policy holder.'

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"The principle that mutuality involves insurance at cost has likewise been applied by this court to fire insurance companies. In MacLaughlin v. Philadelphia Contributionship, 1934, 73 F.2d 582, 584, certiorari denied 294 U.S. 718, 55 S.Ct. 544, 79 L. Ed. 1251, this court was called upon to construe Section 231(11) of the Revenue Act of 1926, 26 U.S.C.A. Int. Rev. Code § 101(11), which accorded to mutual fire insurance companies a tax exempt status.

The court held that the taxpayer was not entitled to tax exemption because it did not use or hold its income solely for the payment of losses and expenses but rather for investment for the benefit of its members. Commenting upon the section which provided the tax exemption we said: 'But section 231(11) was intended to apply to those mutual insurance companies whose sole purpose is to provide protection for its members at cost. In such organizations, the cost of insurance is defrayed by assessments, or payments to meet losses and expenses. The consideration of profits is never involved.'"

In Driscoll v. Washington County Fire Ins. Co., 110 F.2d 485, the court said that the taxpayer was held not to be a mutual company because it lacked democratic control, since but 16 of its more than 3,000 policyholders were entitled to vote to elect directors.

"It will thus be seen that this court has consistently adhered to the view that one of the essential characteristics of a mutual insurance company is that it provide insurance to its members substantially at cost.

"We think that the history of the early development of mutual insurance companies justifies this view. The earliest mutual insurance companies were of the assessment type in which each member was assessed for losses and expenses either immediately upon the happening of the loss or at the end of the year. Because these companies were organized without cash capital and frequently in order to comply with statutory requirements, the members gave premium notes obligating themselves to pay as and when assessed. It is obvious that no profits were possible in such a cooperative organization since the company served merely as a conduit for the collection from the members at large and payment to the particular members suffering losses of the amounts needed to cover their losses. At first it was thought that all mutual companies had to operate upon the assessment principle. The courts, however, soon accepted the view that an insurance company could be a mutual even though it received the premium in cash in advance and even though the policyholder was not subject to assessment. In such a mutual company each member is the insurer of the others only in the sense that his cash premium supplies the capital with which to reimburse other members for losses when they occur."

The court said that the taxpayer was chartered as a mutual fire insurance company in 1843 and that it charged the same rates as stock companies and paid the same brokers' commissions and it did not sell insurance at reduced rates or give rebates to its policyholders. Except in the year 1873 when it issued scrip for $36,377.43, the taxpayer made no distribution by way of dividends of profits or savings or redundancy payments to its policyholders.

"By the express terms of the Pennsylvania statute under which it has operated since June 8, 1938 it is prohibited from making any such payments now or in the future. That statute requires the company to retain all its surplus earnings 'as a reserve for the payment of losses and expenses' and provides that in case of dissolution the surplus remaining after the return of unearned premiums on policies then in force shall escheat to the Commonwealth of Pennsylvania."

The court then proceeded to point out the amount of the earnings of the company which had accumulated over a period of years and said:

"As a result of the accumulation of these earnings the taxpayer's surplus or contingent fund, which on December 31, 1933, had been built up to a sum in excess of $2,800,000, had on December 31, 1938, reached $3,156,049.07. These figures, considered in the light of the fact that but one distribution has been made to its members by the taxpayer in one hundred years of corporate existence, make it abundantly clear that certainly in recent years and probably during most of the taxpayer's history its members have not received their insurance at a figure which even approximated cost. We conclude that the trial judge's findings that the taxpayer does not provide insurance to its members at cost is amply sustained by the evidence. It follows that he correctly held that the taxpayer is not a mutual company within the purport of the Revenue Act and that it is not entitled to be accorded the status of a company wholly tax exempt."

The court further found that in view of the escheat statute of Pennsylvania referred to above, that "Since June 8, 1938, the members of the taxpayer have had no interest in the taxpayer's surplus except as a fund to assure the payment of claims upon their policies." In this connection the court said:

"In a true mutual insurance company the members, if they vote to wind up and dissolve the company, are entitled to receive its net assets upon dissolution. Not so the members of the present taxpayer. They may cause the dissolution of the company but if they do so they are entitled to receive out of its assets only the return of the unearned premiums under their policies then in force. The balance of the company's assets must then pass into the treasury of the Commonwealth of Pennsylvania. There is thus disclosed such a lack of interest by the members in the taxpayer's assets as to take the taxpayer out of the statutory class of mutual insurance companies upon this ground alone."

Attention is called to the fact that paragraph (11) of Section 101 of 26 U.S.C. was amended in 1942 so as to read as follows:

"Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000."

Fair Labor Standards Act - Area of Production

Certain employees of Holly Hill Fruit Products Company, a cooperative corporation engaged in the packing and canning of citrus fruit at Davenport, Florida, brought suit against the cooperative "for wages, overtime, and statutory penalties alleged to be due them by reason of the failure of their employer to comply with the minimum-wage and maximum-hour requirements (Sections 6 and 7 of the Fair Labor Standards Act" (29 U.S.C.A. 201 et seq.). Judgment was rendered in favor of the employees.

The cooperative then appealed to the Circuit Court of Appeals for the Fifth Circuit, which reversed the judgment of the trial court (Holly Hill Fruit Products v. Addison, 136 F. 2d 323).

It was admitted by the cooperative that the wage and hour requirements of the Fair Labor Standards Act had not been observed by it, but the cooperative contended that they were not applicable to its employees -

> ". . . because of the provisions of Section 13(a) (10) of said Act, 29 U.S.C.A. § 213(a) (10). This section provides that Sections 6 and 7 of the Act shall not apply with respect to any individual employed within the area of production (as defined by the Administrator) engaged in handling, packing, storing, preparing in their raw or natural state, or canning agricultural or horticultural commodities for market. It is plain that these employees were engaged in handling, packing, preparing, and canning agricultural or horticultural commodities for market; and the decisive question is whether they performed these activities within the area of production as defined by the Administrator."

The Administrator of the Fair Labor Standards Act had defined the term "area of production." In this connection the Circuit Court of Appeals said that the operations of the cooperative were -

> ". . . seasonal, conforming with the harvesting of citrus fruit, and during the two seasons involved in the period covered by this suit it engaged in business from November 14, 1938, to May 26, 1939; and from November 16, 1939, to March 30, 1940. The Fair Labor Standards Act became effective on October 20, 1938, and as of that date the Administrator promulgated Section 536.2 of his Regulations, which provided that an employee was within the area of production under Section 13(a) (10) of the Act if the agricultural or horticultural commodities were obtained by the establishment where he was employed from farms in the immediate locality and the number of employees in such establishment did not exceed seven. The regulation was amended on April 30, 1939, by the addition of a paragraph providing that, with respect to the preparation or canning of perishable or seasonable fresh fruits, an employee was within the

area of production if the employer's establishment was located in a rural community and obtained all of its products from farms in the immediate locality. It was further provided that the term 'rural community' should not include any town of 2,500 or greater population, and the term 'immediate locality' should not include any distance of more than 10 miles.

"Effective as of June 17, 1939, the regulation again was amended to provide that a worker was employed within the area of production within Section 13(a) (10) if he performed his packing or canning operations on commodities that came from farms within the general vicinity of the employer's establishment, and the number of employees engaged therein did not exceed seven."

The court then held that the restriction in the regulation defining area of production and exempting therefrom employees of employers where the number employed did not exceed seven, was invalid. The court then said:

"Conceding without deciding that the remaining portion of the regulation is valid, the question is whether the commodities used by the establishment came from farms in the immediate locality. The evidence shows that 97.24 percent of the commodities came from farms located within 10 miles of the establishment, and 96/100 of one per cent could not be traced; the balance came from farms less than 25 miles distant. The overwhelming percentage of the fruit obtained from farms within 10 miles was certainly within the immediate locality, and it would be most unreasonable to say that the negligible quantity obtained from a slightly greater distance should affect the statutory concept of area of production."

The court then held that "substantially all of the commodities" were produced within the area of production and held that the employees of the cooperative were not within the scope of the Fair Labor Standards Act.

The employees then appealed the case to the Supreme Court of the United States and that court, in Addison v. Holly Hill Fruit Products, 64 S. Ct. 1215, reversed the Circuit Court of Appeals. The court held that the Circuit Court of Appeals was correct in holding that the Administrator of the Fair Labor Standards Act could not define area of production so as to include a qualification based on the number of employees employed by an employer. But the court held that the Circuit Court of Appeals was in error in holding that the regulation of the Administrator defining the term "area of production" was applicable after deleting the part thereof regarding the number of employees. The Supreme Court said:

"Since the provision as to the number of employees was not authorized, the entire definition of which that limitation was a part must fall." (Underscoring added.)

The Supreme Court then held that the case should be referred to the District Court with instructions to hold the case in abeyance until the Administrator of the Fair Labor Standards Act had defined the term "area of production" in a manner consistent with the authority conferred upon him by Congress. In this regard the court said:

"Concluding, then, that when Congress granted exemptions for workers within the 'area of production (as defined by the Administrator)' it restricted the Administrator to the drawing of geographic lines, even though he may take into account all relevant economic factors in the choice of areas open to him, the regulations which made discriminations within the area defined by applying the exemption only to plants with less than seven employees are ultra vires. But that leaves the difficult problem of the proper disposition of the case. It is our view that the case should be remanded to the district court with instructions to hold it until the Administrator, by making a valid determination of the area with all deliberate speed, acts within the authority given him by Congress.

"Such a disposition is most consonant with justice to all interests in retracing the erroneous course that has been taken. Neither law nor logic dictates an 'either-or' conclusion--that is, a conclusion that the employment in these industries is entirely exempt because the Administrator misconceived the bounds of his regulatory powers although plainly enough he meant to exercise them so as not to withdraw all these employments from the requirements of the Act, or that employment in these industries is subject to the Act because no exception excludes it. The two opposing alternatives do violence to the law as Congress wrote it. To hold that all individuals 'engaged in handling, packing, storing, ginning, compressing, pasteurizing, drying, preparing in their raw or natural state, or canning of agricultural or horticultural commodities for market, or in making cheese or butter or other dairy products' are exempt from the operation of the Act is obviously to fly in the face of Congressional purpose. The Act exempts some but not all of the employees engaged in these industries, and it is not for us now to say that all are exempt. So to hold would postpone the operation of the Act in the enumerated instances for at least six years beyond the date fixed by Congress. Equally offending to the purposes of Congress and therefore to fairness in this situation is the suggestion that if the exemption falls all employees engaged in the designated industries are covered by the Act.

"The accommodation that we are making assumes, what we must assume, that the Administrator will retrospectively act as conscientiously within the bounds of the power given him by Congress as he would have done initially had he limited himself to his authority. To be sure this will be a retrospective judgment, and law should avoid retroactivity as much as possible. But other possible dispositions likewise involve retroactivity, with the added mischief of producing a result contrary to the statutory design."

Several of the Justices dissented on various grounds, but all of the dissenting Justices were of the opinion that the disposition made of the case - namely, remanding it to the District Court to await action of the Administrator in defining the term "area of production" in a manner consistent with his authority - was wrong. Referring to this situation, one of the dissenting Justices said:

> "The administrative process has increasingly important functions in our legal system. Ordinarily it does enough, if it takes care of today and tomorrow. When it begins to add yesterday, without clear congressional mandate, the burden may become too great. In any event, that has not heretofore generally been considered its task. If that task is to be added, the addition should be made by the body whence administrative power is derived, not by this Court's imaginative resourcefulness."

Contrary to the holding of the Circuit Court of Appeals, the majority opinion held that the definition of area of production of the Administrator of the Fair Labor Standards Act, requiring that all of the products handled by an employer must be obtained from within ten miles of the establishment, meant "all" and not "substantially all" as held by the Circuit Court of Appeals.

For other cases arising under the Fair Labor Standards Act see: Fleming v. Farmers Peanut Company, 128 F. 2d 440, discussed in Summary No. 16, page 16, and Holt v. Barnesville Farmers Elevator Co., 52 F. Supp. 468, discussed in Summary No. 22, page 11.

Scope of Federal Milk Order No. 41

In Barron Cooperative Creamery v. Wickard, Secretary of Agriculture, 140 F. 2d 485, a ruling of the Federal Milk Market Administrator for the Chicago area, reclassifying and repricing certain milk under Federal Milk Order No. 41, was held invalid as outside the scope of the Order.

The Secretary of Agriculture, after public hearings, promulgated Order No. 41, effective September 1, 1939, regulating the handling of milk in the Chicago milk marketing area. Section 941.4 of the Order provided for the classification of milk sold in the area as follows:

> "Sec. 941.4. Classification of milk. (a) Basis of Classification. All milk purchased or received by a handler from producers, associations of producers, and other handlers, including milk produced by him, if any, shall be classified by the market administrator in the classes set forth in paragraph (b) of this section.
>
> "(b) Classes of Utilization. The classes of utilization of milk shall be as follows:
>
> "(1) Class I milk shall be all milk disposed of in the form of fluid milk, and all milk not accounted for as Class II milk or Class III milk.
>
> "(2) Class II milk shall be all milk, except skimmed milk, disposed of in the form of flavored milk and flavored milk drinks, all milk used to produce cottage cheese, and all milk used to produce cream which is disposed of in the form of cream (for consumption as cream), ice cream, and ice cream mix.
>
> "(3) Class III milk shall be all milk used to produce a milk product other than one of those specified in Class II, and all milk accounted for as actual plant shrinkage, but not to exceed 2 percent of the total receipts of milk from producers."

The court made the following comments on the foregoing quotation from the Order:

> "Class I is the highest priced milk, Class II is next highest, and Class III is next. It will be seen from this classification that milk used to make ice cream is in Class II, while milk used to make butter is in Class III. The purpose of this classification according to utilization is to guide the Administrator in periodically setting the uniform minimum price to be paid producers for all milk purchased during the period. All producers receive the same price. Adjustments are then made with the first handlers through the producer-settlement fund. If a first handler has disposed of milk in a use which has been assigned a higher price than the uniform

minimum price, he must pay the difference into the settlement fund. On the other hand, if a first handler has disposed of milk in a use which has been assigned a lower price than the uniform minimum price, he is paid the difference out of the settlement fund. The prices assigned to each use classification, as well as the uniform minimum price, are revised each period."

The court further said:

"Order 41 remained in force until July 1, 1940, when there became effective an amended order specifically providing for the reclassification of milk used to produce butter where subsequently such butter was used to make ice cream or ice cream mix.

"During May and June, 1940, while the original order was still in effect, the plaintiffs, who were cooperative associations in Wisconsin, purchased milk from producers which they manufactured into unsalted butter. They sold this unsalted butter to the Bowman Dairy Company of Chicago, who in turn sold it to the Goldenrod Ice Cream Company of the same city for use in making ice cream. There is no intimation that these transactions were not bona fide or that they were part of a scheme to avoid a higher classification under Order 41. The plaintiffs reported the milk thus used to the Administrator of the Chicago Area as Class III milk, the classification for milk used to make butter. The Administrator, however, claimed that the proper classification was Class II, because the butter had ultimately been used by the Goldenrod Company to make ice cream. The difference in price between Class II and Class III for the two months amounted to a total for both plaintiffs of over $11,000.

"The plaintiffs petitioned the Secretary of Agriculture for relief from this claim of the Administrator. After a hearing, the Secretary sustained the Administrator. The plaintiffs then filed a petition for review with the District Court for the Western District of Wisconsin. The Secretary of Agriculture filed an answer and a motion for summary judgment which incorporated the transcript of the proceedings on the plaintiffs' petition before the Secretary. The District Court sustained the Secretary's motion for summary judgment and entered judgment that the Secretary's action was in accordance with law.

"There is no dispute as to the facts. The question is whether Order 41 authorized the rescaling upward of the classification of milk used to manufacture butter, where the purchaser of that butter twice removed used it to make ice cream?

"Paragraph (c) of Section 941.4 of the original Order 41 provided:

"'(c) Interhandler and Nonhandler Sales. Milk disposed of by a handler to another handler, and milk disposed of by a handler to a person who is not a handler but who distributes milk or manufactures milk products shall be classified as Class I milk: Provided, That if the selling handler on or before the 7th day after the end of the delivery period furnishes to the market administrator a statement which is signed by the buyer and seller that such milk was disposed of as Class II milk or Class III milk, such milk shall be classified accordingly, subject to verification by the market administrator.'

"From this, the Secretary argues that since the order provided for a scaling downward of the classification if the disposition of the milk so warranted, it is only fair that a scaling upward be allowed where the milk was ultimately used for a purpose calling for a higher classification, no matter how many times removed from the original handler the changed use took place. We are not required to refute this argument, which might very properly be made to a Congressional Committee or to the Secretary at a public hearing where he was seeking to formulate an order. We are not considering the kind of an order the Secretary could have made but the kind of an order he did make. In the order as originally promulgated and in force when the transactions in this case took place, we find no such authorization for reclassification upward.

"By the terms of Order 41, the classification of the milk was based upon the disposition made of it by the handler. If he disposed of milk as fluid milk or in some manner other than as Class II or Class III, it was Class I milk. If he disposed of milk as flavored milk or flavored milk drinks, as cottage cheese, or to produce cream which is disposed of in the form of cream, ice cream, or ice cream mix, it was Class II milk. Class III was all other milk used to produce milk products.

"Nothing in this order required the handler to look beyond his own disposition of the milk. Nothing in the order required him to pursue the milk and milk products to see in what use classification they were ultimately disposed of. If the handler disposed of the milk in the form of butter in good faith and not colorably to avoid this order, the classification was fixed by the disposition he made of the milk and not by the disposition or utilization some one else made at some subsequent time. The plaintiffs' sale of their butter to the Bowman Dairy Company was the disposition for which they were required to account. The resale of the butter in the form of ice cream by Bowman's vendee was not a disposition made by the plaintiffs for which they could be held accountable under the order.

"Administrative orders, like statutes, are not to be given strained and unnatural constructions. As was said in Lynch v. Alworth-Stephens Co., 267 U.S. 364, 370, 45 S.Ct. 274, 276, 69 L.Ed. 660, quoting from the Circuit Court's opinion, Id., 8 Cir., 294 F. 190, 194: ' * * * the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.' The language of a regulation should be considered as intended to guide and not to entrap those who are governed by it. If the plaintiffs are held accountable for the Secretary's unnatural and unusual construction of Order 41, they are being saddled with a responsibility not delineated by the order and with a surprise burden impossible to anticipate, which, unwarned, they had no opportunity to take steps to protect themselves against. The order, instead of a blazed trail for their guidance, would be a snare for their entrapment. Administrative orders of that character are unlawful."

The court called attention to the amendment to Order 41, which became effective July 1, 1940, "to provide expressly for the liability which the Secretary here would place upon the plaintiffs," and the court said of this amendment:

"This is tantamount to an admission by the Secretary that the order as originally promulgated did not cover the reclassification upward which he would compel the plaintiffs to assume in this case."

Labor Cases

In the case of Utah Poultry Producers Cooperative Association v. Utah Labor Relations Board, the Supreme Court of Utah (149 P. 2d 643) set aside an order of that board finding that the association was guilty of unfair labor practices under the laws of that State by discharging from its employment the complainant, Willis L. Jacobson.

The question at issue was whether the association had discharged the complainant because of union activity. The Utah Labor Relations Board held that the facts showed the complainant had been discharged for such activity. The question involved was entirely one of fact. It appeared that the workers at the plant of the cooperative association had in 1938 affiliated with a union of the American Federation of Labor and the association entered into a closed shop agreement therewith. In 1939, the employees at the plant called a meeting and all but 13 voted to secede from the American Federation of Labor union and to form an independent union of poultry employees. This was done. An election was held in accordance with regulations of the National Labor Relations Board and an independent union was certified as the bargaining agent. This union then negotiated with the cooperative for a new contract. The complainant Jacobson, as First President of the new union, was active in these negotiations. There was evidence that the complainant Jacobson had shown an uncooperative attitude toward the cooperative. The trial examiner of the State Labor Relations Board apparently was of the opinion that an "inefficient leadership" of the union was "the result of company domination." In this connection, the Supreme Court of Utah said:

> "It is the membership of the union which has the right to provide its leadership and unless there is evidence of company interference in such selection, the action of the union membership in making choice of their officers and in directing their activity is no concern of the Board. The right of self organization is guaranteed by the law. That right is defeated if interfered with by the Board as truly as by the intermeddling of the employer. It is certainly unwarranted here to infer from the mere fact of a lack of aggressive leadership that such condition resulted from company domination. The finding of such domination and interference finds no substantial support in the record."

In National Labor Relations Board v. Dadourian E. Corporation, 138 F.2d 891, the court held that an election of a bargaining agent had been vitiated because four votes, some of which were needed to give the union a majority, had been cast therefor as the result of the four workers being told in effect that if they did not join the union they could not work there any more. Referring to the false statements made to these workers, the court said:

> "Fraud -- which this was -- will vitiate consent as well as violence, and the Board itself implies that a vote procured by violence should

not be counted. It is quite true that only an employer can be guilty of 'unfair labor practices,' (§8), but §7 confers the right on all employees freely to choose their bargaining representatives, and the invasion of that right is as much a wrong, when committed by a union organizer as by an employer. The fact that when it is not committed by an employer, the Board has no power to use its peculiar remedies to effectuate the policies of the act, must not blind us to the fact that those policies include employees' freedom from interference with their choice of representatives from any source whatever.

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"Nor can we see that the absence of any proof of Capra's authority to act for the union is material. Since the issue is of protecting the rights granted to all employees by the act, its policies are as much frustrated whether an authorized agent of the union is the actor or someone else; for the overriding consideration must always be the employees' untrammelled freedom of choice; upon that the whole framework rests. Moreover, even were we to disregard that dominant consideration, the right of a union to act as bargaining agent depends upon the votes of the employees, and, if it accepts and uses their votes, it necessarily ratifies the means by which they have been procured, even though it did not authorize them in the first instance. That follows from ordinary principles of agency. We hold that the four votes should not have been counted, and that the union was never chosen by a majority of the 'unit' as its bargaining agent."

This is said to be the first case in which a court has applied the principles involved. See 57 Harv. L. Rev. 386, and 42 Mich. L. Rev. 1140.

Forfeiture of Charter for Nonuser

Stockholders of the Farmers Union Cooperative Brokerage instituted court proceedings for the purpose of bringing about a dissolution of that corporation. Some of the stockholders of the corporation opposed the dissolution and the court, in Farmers Union Co-operative Brokerage v. Palisade Farmers Union (S.D.) 7 N.W. 2d 293, held that the requirements fixed by statute for dissolution had not been met (see Summary No. 18, page 16).

Thereafter, stockholders of the corporation who desired to bring about its termination had a proceeding instituted by the State's Attorney in and for McCook County, South Dakota, they appearing as the relators for the forfeiture of the charter of the corporation for nonuser, and in State v. Farmers Union Cooperative Brokerage, 13 N. W. 2d 809, the Supreme Court of South Dakota upheld the judgment of the lower court decreeing a forfeiture of the franchise of the corporation. That court said:

> "That the Farmers Union Co-operative Brokerage is a corporation organized under the laws of this state for the purpose of handling and selling farm machinery, wire, fencing, oil, gasoline, and all kinds of farm machinery and equipment; that about one year previous to the commencement of this action the corporation reduced its assets to cash, withdrew from business and has not since exercised its franchise; that dissension exists among its stockholders; and that the majority in number and over ninety per cent in interest of its stockholders favor dissolution and are opposed to a resumption of its business activities."

It appeared that a statute of South Dakota provided for vacating the charter or articles of incorporation of a corporation. The applicable statutory provision reads as follows:

> "An action may be brought by any state's attorney in the name of the state or by any person who has a special interest in the action, on leave granted by the Circuit Court or Judge thereof, for the purpose of vacating the charter or articles of incorporation, or for annulling the existence of corporations other than municipal, whenever such corporation shall: * * *
>
> "(3) Have forfeited its privileges of franchises by a failure to exercise its powers." SDC 37.0502.

In this connection the court quoted the following from 16 Fletcher, Corporations (1942) §8061:

> "It has been said that it is an implied condition of every corporate charter that the grantees shall act thereunder up to the expiration of the time for which they are incorporated, and if they fail to do

so, the franchises granted may be withdrawn. And, as a general proposition, this is true. It is generally conceded that every legislative grant creating corporate existence is subject to the condition that the privileges and franchises conferred be used in the manner designated in the grant and in compliance with the law, and that a failure therein for an unreasonable length of time, whether through neglect, design or misfortune, is a breach of the implied agreement under which the right was granted and authorizes the state to repossess itself of that right."

The court further said:

"The total nonuser of its franchise has been said to constitute a ground for forfeiting the charter of a purely private corporation in the absence of statute. 16 Fletcher, Corporations §8061; State v. Dilbeck, Tex.Civ.App., 297 S. W. 1049; 13 Am.Jur. 1171; annotation, 8 Am.St.Rep. 179. Such total nonuser goes to the essence of the implied agreement between the state and the incorporators and justifies the state in claiming a forfeiture of the rights and privileges of the corporation.

"In this jurisdiction the right of the state to repossess itself of the granted rights and privileges in such a case has been declared by the quoted statute. This statute was applied in forfeiting the charter of a private corporation in State ex rel. Denu v. Rapid City Library Association, 32 S.D. 248, 142 N.W. 973. * * *

"The courts, having regard for the value and importance of the right to exist as a juristic person, have ever been cautious in decreeing a forfeiture of a corporate charter. 16 Fletcher, Corporations, §8035. That the Legislature intended to safeguard these valuable privileges is indicated by the fact that it clothed the courts with a measure of discretion in determining whether an action seeking a forefeiture of such privileges should be commenced. We think it reasonable to conclude that the Legislature did not intend that every halt of corporate activity should give rise to a cause of action in the state. Circumstances can be conceived in which a temporary total suspension of business might be such an act of prudence as would ultimately contribute to the social and economic purposes underlying the grant of corporate existence. However, we do not doubt that the statute is satisfied, and a ground of forfeiture is established by showing a complete discontinuance of effort to accomplish the purposes for which the corporation was chartered, <u>and either an intention not to carry on, or an inability so to do</u>.

"In the instant case, although the company has been at a standstill for a period of but a year, it appears that its cessation of effort to carry out the purpose for which it was chartered is not only intentional, <u>but is final in character</u>. All but a very small

minority of those interested are opposed to a resumption of operations. We are of the opinion that nonuser, such as is contemplated by the statute, was established, and that the findings support the judgment." (Underscoring added.)

It was urged on appeal that the relators, through the proceeding to forfeit the charter of the corporation, were accomplishing the identical object that they failed to accomplish in the proceeding for a voluntary dissolution of the corporation. In this connection the court said:

> "In other words, it is apparent that the judgment sought and obtained serves the private interests of these relators and others. That such is the case is without legal significance if the judgment serves the public interest. People ex rel. Golconda Northern Ry. Co. v. Toledo, St. L. & N. O. R. Co., 280 Ill. 495, 117 N.E. 701, Ann.Cas.1918D, 224; 44 Am.Jur.99. The question for decision is whether the state established a statutory ground warranting the judgment vacating the charter of the defendant corporation."

Workmen's Compensation Act

The holding of the Supreme Court of Idaho in the case of Arbogast v. Jerome Co-op. Creamery, 149 P. 2d 230 is epitomized in the headnote as follows:

> "Making drying trays which were an essential part of equipment of creamery engaged in manufacture of casein was as to creamery only 'casual employment' excluded from coverage of Workmen's Compensation Act, in absence of showing of a regular or periodical custom of creamery to employ workmen to make such trays or that employment of workmen to make trays was essentially a part of creamery's business. Code 1932, §43-904."